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Supreme Court, U.S.
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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1999

THE CHARLES SCHWAB CORPORATION and INCLUDABLE SUBSIDIARIES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Background

Virtually all business taxpayers must report their income and deductions for federal income tax purposes using an accrual method of accounting. Under applicable income tax regulations, and as enunciated by this Court in, inter alia, United States v. General Dynamics Corp., 481 U.S. 239 (1987), the benchmark standard for accrual accounting is the "all events" test. Under that test items of income and deduction accrue when all events have occurred to fix the right to income (or the liability for an expense) and the amount of the item can be determined with reasonable accuracy.

Question

Under the "all events" test, is a business taxpayer taxable on income from a transaction only when it completes all activities that are required by the contract for the transaction, in conformity with General Dynamics, or may it be subject to tax when it has completed a lesser set of activities that are deemed "essential" to the transaction even though the contract requires the taxpayer to perform additional activities to earn the right to payment of the income?

CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 29.6 of the Supreme Court Rules, Petitioners hereby certify that The Charles Schwab Corporation has no parent corporation and that no publicly held company owns ten percent or more of its stock.

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OPINION AND ORDERS BELOW

The Order of the United States Court of Appeals for the Ninth Circuit is unpublished; a copy of the Order is included as Appendix A. The Opinion of the United States Tax Court is published at 107 T.C. 282 (1996); a copy is included as Appendix B.

JURISDICTION

On December 9, 1998, the Ninth Circuit entered an unpublished Order adopting the reasoning of the United States Tax Court in Charles Schwab Corp. v. Commissioner of Internal Revenue, 107 T.C. 282 (1996), and affirming the Tax Court's decision (the "Order").

On March 17, 1999, the Ninth Circuit entered an order denying Petitioners' petition for rehearing and suggestion for rehearing en banc.

This Court has jurisdiction under 28 U.S.C. § 1254 to review the Order on a writ of certiorari.

APPLICABLE REGULATIONS

This case involves the interpretation and application of 26 C.F.R. ("Treas. Reg.") §§ 1.446-1(c)(1)(ii), 1.451-1(a), and 1.461-1(a)(2), set forth below as they appeared in the taxable years in issue.

As relevant here, Treas. Reg. §1.446-1(c)(1)(ii) provides:

> Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy.

As relevant here, Treas. Reg. §1.451-1(a) provides:

> Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

As relevant here, Treas. Reg. §1.461-1(a)(2) provides:

> Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy.

STATEMENT OF THE CASE

In this case, Respondent (the "Commissioner") seeks to tax income before the taxpayer has completed the tasks required by its contract with its customer to earn the income. This result is contrary to settled case law, and specifically is contrary to this Court's decision in United States v. General Dynamics Corp., 481 U.S. 239 (1987).

Petitioner Charles Schwab & Co. ("Schwab") is the largest and best-known discount brokerage firm in the nation.

Most of Schwab's income comes from brokerage commissions. Each brokerage transaction involves a "trade" date and a "settlement" date. The "trade" date is the day the customer places an order to buy or sell securities. On the trade date, Schwab "executes" the order by locating a contra-broker who represents a person wanting to be on the other side of the transaction. That is, if the order is a buy order, Schwab in effect matches its customer with a seller. If the order is a sell order, Schwab matches its customer with a buyer. This process is done by computer and requires little time. For example, when an order is placed by telephone during an exchange's business hours, Schwab is generally able to match it with a seller or buyer while Schwab's customer is still on the telephone.

On the "settlement" date, five business days later (during the taxable years in issue), Schwab completes — "settles" — the transaction by physically effecting an exchange of its customer's cash for securities in the case of a purchase or of its customer's securities for cash in the case of a sale.

Schwab's standard customer contract requires the customer to pay Schwab for transactions in the customer's brokerage account. Schwab's bill to the customer requires payment by the settlement date. If Schwab does not settle a transaction, it has no contractual right to payment.

For federal income tax purposes as well as for financial reporting purposes, Schwab adopted an accrual accounting method under which it takes its commissions into income on the "settlement" date — the date on which money and securities are actually exchanged and Schwab is contractually entitled to its commission.

The Commissioner issued a statutory notice of deficiency in federal income tax to Petitioners on December 12, 1991, asserting (as relevant here) that Schwab was obligated to account for its commission income as of the "trade" date of each brokerage transaction — the date on which Schwab receives an order and matches it with a seller or buyer.

Petitioners timely filed a petition for redetermination of tax to the United States Tax Court. The statutory basis of the Tax Court's subject-matter jurisdiction is set forth in 26 U.S.C. ("I.R.C.") § 7442. The Tax Court held in the Commissioner's favor. It characterized Schwab's activities after the trade date, including settlement, as not "essential" but as "ministerial" and as "conditions subsequent" rather than "conditions precedent" to the accrual of Schwab's commission income.

Petitioners timely appealed the Tax Court's decision to the Ninth Circuit Court of Appeals. The Ninth Circuit's

jurisdiction over the appeal is set forth in I.R.C. § 7482(a)(1). The Ninth Circuit adopted the Tax Court's reasoning and decision and denied Petitioners' petition for rehearing en banc. This Petition followed.

REASONS FOR GRANTING THE WRIT

This case of first impression raises a fundamental issue regarding the accrual of income for purposes of the federal income tax. Because it involves a basic principle of accrual accounting, this case potentially affects every business taxpayer in the nation.[1]

This Petition should be granted because the decision of the Tax Court, adopted by the Ninth Circuit: (1) conflicts with the decision of this Court in United States v. General Dynamics Corp., 481 U.S. 239 (1987), and (2) announces an open-ended and poorly reasoned new standard of accrual accounting that, if allowed to stand, can only confuse and burden the nation's taxpayers and courts for decades to come.

The benchmark rule of accrual accounting for federal income tax purposes is the "all events" test: Items of income (or deduction) accrue when "all the events have occurred

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[1] Virtually all business taxpayers are required to use an accrual method of accounting. Treas. Reg. § 1.446-1(c)(2)(i) requires every taxpayer using an inventory to use the accrual method for purchases and sales. I.R.C. § 448 requires regular ("C") corporations with annual gross receipts of at least $5 million to use an accrual method (by forbidding use of the cash method). And I.R.C. § 447(a) requires corporations engaged in most farming activities to use an accrual method.

which fix the right to receive such income [or the liability for the deduction] and the amount thereof can be determined with reasonable accuracy." Treas. Reg. §1.446-1(c)(1)(ii).[2]

The decision of the Ninth Circuit and the Tax Court injects substantial and irremediable uncertainty into the "all events" test by re-defining "event" so that a contractually required act does not count as an "event" unless it is an "essential" part of the services or goods offered by the taxpayer. In this context, however, the term "essential" has no readily ascertainable meaning: What is "essential" to one taxpayer may be merely desirable to another and trivial to a third. The courts below compounded this error by mischaracterizing non-"essential" actions as both "ministerial" in nature and "conditions subsequent" to the accrual of income. In so doing, the lower courts borrowed, and mis-applied, the term "ministerial" from a decision of this Court and confused the meanings of "condition precedent" and "condition subsequent."

Worse, however, from the perspective of the nation's taxpayers and courts, is that neither the Ninth Circuit nor the Tax Court offered any view as to the qualities that cause some contractually required events to be deemed "essential," non-"ministerial," and "conditions precedent" while others are deemed non-"essential," "ministerial," and "conditions subsequent." As a result, all accrual method taxpayers are left to ponder which of their income-producing activities are

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[2] All citations to Treasury Regulations are to the regulations as they appeared in 1988, the taxable year in issue.

in some sense "essential" and constitute "events" in the "all events" test and which are less important and subject to attack by the Commissioner.

The ambiguity and subjectivity of the standard proposed by the Ninth Circuit and the Tax Court are in stark contrast to the clear and hard-edged standard enunciated by this Court in General Dynamics, supra: If an activity is contractually required, then it is an "event" and must occur before the income accrues under the "all events" test. If the decision of the Ninth Circuit and the Tax Court is allowed to stand, it will undermine the standard of General Dynamics. Given that the meaning of "event" lies at the heart of the "all events" test, and that uniformity and predictability are of paramount importance in tax accounting methods, this Petition should be granted.

A. The Lower Courts' Decision Conflicts with this Court's Decision in General Dynamics.

In General Dynamics, supra, the issue was when "all events" had occurred to establish the taxpayer's liability to reimburse its employees for medical care. The taxpayer's reimbursement plan required employees who had received medical care to submit claim forms in order to be reimbursed. This Court held that "all events" had occurred only when the taxpayer received the claim forms:

> General Dynamics was thus liable to pay for covered medical services *only* if properly documented claims forms were filed. [General Dynamics, supra, 481 U.S. at 244; emphasis in original.]

The possibility that employees would fail to file claims for reimbursement after having received and paid for medical care was acknowledged to be an "extremely remote and speculative possibility." Id., at 244 (citation omitted).[3] This Court nonetheless held that under the "all events" test, the taxpayer's reimbursement obligation did not accrue until a claim form was filed. This Court found that since submission of the claim form was the "last link in the chain of events creating liability for purposes of the 'all events' test," id., the possibility of non-submission was not "the type" of "remote and speculative" contingency that would cause the submission of a claim to be disregarded as a required "event." In other words, because the filing of a claim was a legal precondition to the taxpayer's liability, it intrinsically constituted an "event" under the "all events" test:

> Such filing is not a mere technicality. It is crucial to the establishment of liability on the part of the taxpayer. [Id.]
>
> * * *
>
> We conclude that, as a matter of law, the filing of a claim was necessary to create liability. [Id., at n.4.]

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[3] Indeed, the dissent characterized the prospect of non-filing of claims as "at most a 'merely formal contingenc[y], or [one] highly improbable under the known facts.'" Id., at 250 (O'Connor, Blackmun, Stevens, JJ., dissenting; citations omitted).

The instant case is indistinguishable from General Dynamics. Here, as in General Dynamics, the taxpayer is subject to contractual terms that are not satisfied until a highly probable final act is performed. In General Dynamics, the final act that gave rise to liability was submission of the claim form. Here, the final act that establishes Schwab's contractual right to its commission income is Schwab's settlement of the transaction. It follows that, under the standard established by this Court in General Dynamics, settlement was "crucial to the establishment" of Schwab's right to its commission.[4]

Under Schwab's contractual arrangements with its customers, a customer is not obligated to pay Schwab its commission until Schwab has settled the particular transaction for the customer by physically effecting an exchange of the customer's securities for cash (if the transaction is a sale) or of the customer's cash for securities (if the transaction is a purchase). Under the standards established by this Court in General Dynamics, Schwab is therefore not obligated to accrue its commission as taxable

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[4] Although General Dynamics concerned accrual of deductions, the language of the "all events" test is the same for both the accrual of income and the accrual of deductions. Compare Treas. Reg. §§ 1.451-1(a) (income) and 1.461-1(a)(2) (deductions). Moreover, General Dynamics has been applied by two Circuit Courts of Appeals and the Tax Court to the accrual of income. Resale Mobile Homes, Inc. v. Commissioner, 965 F.2d 818, 823 (10th Cir. 1992); Lamm v. Commissioner, 873 F.2d 194, 196 (8th Cir. 1989); Beauty Acquisition Corp. v. Commissioner, 69 T.C.M. (CCH) 1971, 1977, T.C. Memo. 1995-87 (1995).

income until the settlement date, when it achieves the right to payment, because only then is Schwab's contractual right to the commission "firmly established." Id., at 243.

The Ninth Circuit/Tax Court decision nonetheless held that Schwab's settlement-date activities were to be disregarded under the "all events" test, based on an erroneous characterization of those services as non-"essential" and "ministerial":

> [Schwab] argues that its commission is earned when delivery of the securities and payment of the purchase price occur, which is not until the settlement date ... [The Commissioner], on the other hand, argues that execution of an order on behalf of a customer is the essential service that [Schwab] performs and is the time at which [Schwab's] right to receive, and the customer's obligation to pay, the commission arises. According to [the Commissioner], all the actions that remain to be performed by [Schwab] after the trade date are of a ministerial nature to effectuate the mechanics of the transfer and are merely in confirmation of the trade executed. We agree with [the Commissioner].
>
> [Schwab] is a member of all major U.S. securities exchanges. The essential service that [Schwab] provides to its customers is the execution of trades through its access to the securities exchanges. It is through this access that the customer acquires the ability to make

a trade. [Schwab, supra, 107 T.C. at 292, App. B, infra, at 17-a.]

In this holding, the Ninth Circuit and the Tax Court committed at least three errors. First, in applying the "all events" test without treating Schwab's contractual duty to complete transactions on the settlement date as an "event," the lower courts ignored this Court's holding in General Dynamics.

Second, the lower courts enunciated no standards for determining what elements cause an activity to be "essential" as opposed to "ministerial," but simply interjected their own judgment as to what feature of Schwab's activities on behalf of its customers they believed to be "essential" to those customers.[5]

Third, the judgment the lower courts made is contradicted not only by Schwab's contract with its customers, but also by plain common sense. Schwab's business is effecting purchases and sales on behalf of its customers. The "essence" of a sale, from a customer's perspective, is the receipt in hand of the net cash proceeds. For a purchaser, it is the delivery of the securities purchased. The mechanics of effecting the transaction — including

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[5] As discussed in greater detail below, this impetus to interject subjective judgment was not a fluke — the "essential" vs. "ministerial" acts standard adopted by the lower courts inherently constitutes an open, seductive, and treacherous invitation to the Commissioner and the courts to make their own determinations as to which elements of each taxpayer's business are "essential" and which are "ministerial."

execution of the trade on the trade date — are the details. The crucial goal is getting the cash or securities the customer has contracted for.

B. The Lower Courts Misapplied this Court's Decision in Continental Tie & Lumber Co.

The Tax Court and the Ninth Circuit took the term "ministerial" from this Court's decision in Continental Tie & Lumber Co. v. United States, 286 U.S. 290 (1932), and gave it a meaning not intended by this Court.

In Continental Tie, the issue was whether the taxpayer's accrual of income should be delayed after "all events" had occurred to fix the right to income, by the act of computing the exact amount of the income. This Court held that the income accrued when the right to it became fixed and used the term "ministerial," id., at 295, to describe the subsequent administrative procedure of ascertaining, after all events had occurred, the amount of income that had been earned.

In the instant case, the Ninth Circuit/Tax Court decision cited Continental Tie for the proposition that ministerial acts do not affect the time that income accrues,[6] but then misapplied the term to acts that occur before the

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[6] The Ninth Circuit/Tax Court decision cited two additional cases for this proposition, Dally v. Commissioner, 227 F.2d 724, 726 (9th Cir. 1955), which correctly states that the "ministerial act" referred to in Continental Tie was that of computation after the right to income had accrued, and Resale Mobile Homes, supra, also a computation case.

right to the income has been earned. 107 T.C. at 292-94, App. B at 16-a.

The Ninth Circuit and Tax Court compounded this error by then trying to re-explain the difference between "essential" and "ministerial" events in terms of "conditions precedent" and "conditions subsequent:"

> In applying the all events test, this and other courts have distinguished between conditions precedent, which must occur before the right to income arises, and conditions subsequent, the occurrence of which will terminate an existing right to income, but the presence of which does not preclude accrual of income. [Citations omitted.]
>
> We think the above factors indicate that [Schwab's] execution of a trade for a customer is a condition precedent that fixes [Schwab's] right to receive the commission income. The functions that remain to be performed by [Schwab] after the trade date are of a ministerial nature to effectuate the mechanics of the transfer and confirm the trade executed. Although failure to perform these functions may ultimately divest [Schwab] of its right to the commission income, we think that these functions are conditions subsequent and, therefore, do not preclude accrual of commission income on the trade date. [Schwab, supra, 107 T.C. at 293-94, App. B at 18-a, 19-a]

When the courts have defined "condition precedent" and "condition subsequent" for purposes of income accrual, they have in effect said that "conditions precedent" are the events that need to occur so that continuation of the status quo thereafter will result in the receipt of the income. A condition subsequent is an event the later occurrence of which would be inconsistent with the right to receive the income.[7] See, e.g., Wien Consol. Airlines, Inc. v. Commissioner, 60 T.C. 13, 15 (1973), aff'd, 528 F.2d 735, 737 n.4 (9th Cir. 1976); Buckeye International, Inc. v. Commissioner, 49 T.C.M. (CCH) 376, 382, T.C.Memo. 1984-668.

In the instant case, however, the Ninth Circuit and the Tax Court have confused the concepts. Continuation of the status quo at the time of the trade date would not result in receipt by Schwab of its commission, for the basic reason that exchange of the securities for the cash would not yet

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[7] Commentators agree: It is textbook law that the term "condition precedent" denotes an act or event, other than the lapse of time, that must exist or occur before the other contracting party's performance under the contract becomes due. Calamari & Perillo, Contracts, 439 (3rd Ed. 1987); RESTATEMENT (SECOND) CONTRACTS § 225 (1981). In the instant case, clearing and settling a transaction constitute conditions precedent because the customer has no duty to pay a commission until those events have occurred and the customer receives the securities or cash, as the case may be. In contrast, a "condition subsequent" is any event the existence of which, by agreement of the parties, operates to discharge a duty of performance that has already arisen. Calamari & Perillo, supra, at 441; RESTATEMENT (SECOND) CONTRACTS § 230 (1981).

have occurred. If nothing further were affirmatively to happen after the trade date, Schwab's customer would not receive the securities or cash from the transaction in question. And Schwab would not have earned its commission under its contract with its customer. Schwab's activities between the trade and settlement dates are therefore not conditions subsequent, but are acts that Schwab must affirmatively perform if it is to earn its income.

The lower courts nonetheless brushed aside both common sense and the contractual prerequisites to Schwab's right to be paid its commission, by characterizing settlement — as well as other post-trade-date activities — as "conditions subsequent." This characterization highlights the conflict between the present case and General Dynamics, supra. Under General Dynamics, a contractual condition to a right to payment must be a condition precedent and cannot be a condition subsequent.

C. The Inherent Ambiguities of the Lower Courts' Standard Will Confuse the Nation's Taxpayers and Burden the Courts.

A result of the lower courts' mistakes of law is an irremediably ambiguous "essential" vs. "ministerial" acts standard that invites the Commissioner and the courts to substitute their own subjective judgments about what is "essential" to the performance of a contract for the objective determination of whether all contractually required acts have been performed to fix the right to income. Under the lower court's decision, taxpayers will need to divine at what point partial performance is sufficient to trigger income accrual

even though that performance falls short under the contract. And courts, at the Commissioner's insistence, will struggle to apply unhelpful distinctions in the hope of finding what the contract was "really" about. Under the lower courts' decision, the "all" part of the "all events" test becomes a misnomer. And if fewer than "all" events are deemed to satisfy the test, both taxpayers and the courts will be reduced to guessing when income has been earned.

The accrual standard established by this Court in General Dynamics has the considerable virtue of being hard-edged and clear in its application: All contractual pre-requisites to payment (or liability) must be satisfied before accrual occurs. Under the Ninth Circuit and Tax Court decision, only those pre-requisites that are "essential" to performance of the contract need occur. However, the term "essential" does not have a clear meaning, but is likely to vary in meaning from taxpayer to taxpayer.

The instant case is an example. The Tax Court's finding that Schwab's "essential" service is the matching of buyers and sellers on the trade date "through its access to the securities exchanges" was not based on evidence or stipulations regarding customers' reasons for patronizing Schwab, but rather on the court's observation that this access gives "the customer ... the ability to make a trade." Schwab respectfully submits, however, that for virtually all of its customers the "essential" feature of Schwab's business is that, with a very high degree of certainty, orders placed with Schwab result in a settled transaction that secures for a seller the cash from the sale and for a buyer the securities purchased. For these customers, Schwab's access to the

exchanges is a necessary, but not sufficient, element of Schwab's business. It is possible that for some customers, the matching process on the trade date is "essential." Under the lower courts' standard, what should Schwab do to assure accurate accrual accounting? Poll its customers? Accrue income on the trade date for those who agree with the Tax Court and the Ninth Circuit and on the settlement date for those who believe it is "essential" to have cash in hand?[8] Or does the decision of the courts below mean that matching of buyers and sellers is the essential element whatever Schwab's customers — and Schwab itself — actually believe?

The implications of the lower court's decision reach far beyond brokerage firms and service businesses. Consider, for example, a manufacturer of heavy industrial components that maintains both an extensive inventory and a fleet of specialized trucks to make deliveries. For customers in sudden need of a replacement part, the manufacturer's ability to make rapid, assured deliveries may be the "essential" feature, of buying from this manufacturer. For others, the availability of an extensive inventory may be the "essential" feature, and these customers may be relatively indifferent to the timing of delivery. Moreover, the quality that a customer believes to be "essential" may change from month to month or week to week: When the need is sudden, delivery is "essential." When the need is predictable,

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[8] Any such need to differentiate among customers would in itself impose an enormous burden on Schwab's business. During the taxable years in issue, Schwab averaged more than 10,000 transactions per business day.

availability of the component from inventory may be "essential." Under the Ninth Circuit and Tax Court decision, the manufacturer's accounting for sales would change depending upon the needs of the particular customer at the time the order is placed, even though the manufacturer's business practices would be the same for each category of sale.

Or consider a contractor building custom homes to order. Under General Dynamics, the contractor's income would accrue when the construction required by the contract is complete. Under the Ninth Circuit/Tax Court standard, however, the contractor must instead ask itself when the "essential" features of a home are complete. It seems certain that the foundation, walls, and roof would be considered "essential." Wiring and plumbing are probably also "essential." Cabinetry? Uncertain — possibly "essential" possibly "ministerial." Bathroom tile? Again uncertain, but one would guess "ministerial." Carpeting? Probably "ministerial." Kitchen appliances? Probably "ministerial." Painting? Definitely "ministerial." So when, according to the Ninth Circuit and the Tax Court, does the contractor accrue its income? Not upon completion of its contract, but sometime between the time the cabinets are finished and the paint dries, depending upon the collective views of the contractor, the Commissioner and, inevitably, the courts. Moreover, it is a safe guess that different courts will have different views of which features of different taxpayers' businesses are "essential" and which are "ministerial."

Due to this very lack of clarity, the decision of the Tax Court and the Ninth Circuit would bedevil the nation's

corporate taxpayers — and ultimately the courts — as they try to figure out which of the acts a taxpayer performs to earn its income are substantive and important and which are merely "ministerial" (or "conditions subsequent" instead of "conditions precedent").

CONCLUSION

For the foregoing reasons, this Court should grant this Petition and issue a writ of certiorari to the Ninth Circuit.

Respectfully submitted,

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